Nos. 87-453 and 87-464

IN THE

# Supreme Court of the United States

OCTOBER TERM, 1987

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AMERADA HESS CORPORATION *et al.*,
*Appellants*,

v.

DIRECTOR, DIVISION OF TAXATION,
*Appellee*.

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TEXACO INC. and TENNECO OIL COMPANY,
*Appellants*,

v.

DIRECTOR, DIVISION OF TAXATION,
NEW JERSEY DEPARTMENT OF THE TREASURY,
*Appellee*.

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**On Appeal from the Supreme Court of New Jersey**

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## BRIEF OF THE AMERICAN MINING CONGRESS AND THE NATURAL GAS SUPPLY ASSOCIATION AS *AMICI CURIAE* IN SUPPORT OF JURISDICTIONAL STATEMENTS OF APPELLANTS

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WILLIAM L. GOLDMAN*
GEORGE W. BEATTY
JAMES A. RIEDY
LEE, TOOMEY & KENT
1200—18th Street, N.W.
Washington, D.C. 20036
(202) 457-8500

**Counsel of Record*

PRESS OF BYRON S. ADAMS, WASHINGTON, D.C. (202) 347-8203

## QUESTION PRESENTED

Whether the Due Process, Commerce, and Equal Protection Clauses of the United States Constitution permit a State, in defining the apportionable business income of a multi-state unitary business, to include income contributed by an exclusively out-of-state business activity but to exclude associated costs incurred solely on account of that activity.

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## INTRODUCTORY STATEMENT

This brief is submitted by the American Mining Congress and the Natural Gas Supply Association as *amici curiae* in support of the jurisdictional statements filed by appellants in the above-captioned cases. Written consents of the appellants and the appellee have been obtained and filed with the Clerk of the Court.

## INTEREST OF AMICI CURIAE

The American Mining Congress is a nonprofit association of approximately 450 companies that produce a major portion of the Nation's minerals, including coal, metals, and nonmetallic industrial and agricultural minerals. The Natural Gas Supply Association is a nonprofit association of approximately 75 companies that produce and market nearly 90% of the Nation's natural gas. Some of the appellants in this case or their subsidiaries are members of the *amici*.

This case is important to the members of these associations because of the potential impact that the decision of the New Jersey Supreme Court may have on the state tax treatment of expenses similar to the Federal Windfall Profit Tax ("WPT"), particularly



state severance taxes. The *amici* are concerned that, in computing apportionable business income for formulary apportionment purposes, other States will use this case as a road map to obtain larger tax revenues by disallowing deductions for expenses that are incurred only in connection with out-of-state income-producing activities.

## SUMMARY OF ARGUMENT

The decision of the New Jersey Supreme Court to disallow a deduction for the WPT in computing the appellants' New Jersey taxable income has potential ramifications extending far beyond this case. The WPT is similar to state severance taxes and other localized production costs that relate to specifically identifiable production operations with an unambiguous geographical situs. Unless the decision below is reversed, the *amici* are concerned that States in which there is little or no mineral production may attempt to follow the New Jersey approach by disallowing deductions for severance taxes or other mineral production costs incurred outside those States. The amounts potentially involved are substantial.

The underlying issue in this case is to determine the portion of appellants' unitary business income that is attributable to their refining and marketing activities in New Jersey. That is all New Jersey may constitutionally tax. However, New Jersey seeks to tax more. New Jersey seeks to increase the amount of appellants' income apportioned to New Jersey under the standard three-factor apportionment formula by artificially increasing the amount of apportionable business income derived from out-of-state activities. This is accomplished by disallowing a deduction for

an expense that occurs solely outside of New Jersey—the WPT. In substance, the State is including in the appellants' apportionable business income the *gross* revenues derived from the out-of-state activities (oil production with no WPT deduction) and the *net* income derived from New Jersey activities (refining and marketing with deductions for all associated expenses). Such a hybrid definition of apportionable business income necessarily means that New Jersey's share of the appellants' true total net income is increased under the apportionment formula used by New Jersey. This result is inherently arbitrary and a violation of the Due Process Clause of the Constitution. Moreover, by denying out-of-state producers a deduction for certain costs that are effectively deductible by competitors who purchase rather than produce their crude oil or refined products, New Jersey also violates the Commerce and Equal Protection Clauses.

## ARGUMENT

### I. THIS CASE WARRANTS PLENARY REVIEW

#### A. Introduction

The New Jersey Supreme Court's opinion in this case has potential ramifications extending far beyond the specific issue decided by that court. As discussed in Part IB, the WPT involved in this case is similar to state severance taxes and other geographically localized mineral production costs. *Amici* are concerned that if the decision below is permitted to stand, States in which there is little or no mineral production ("non-producing States") may unconstitutionally seek to exploit the decision, in order to increase their income tax revenues, by following the New Jersey approach



and disallowing deductions for severance taxes and other mineral production costs incurred by unitary business taxpayers outside those States. Accordingly, the question presented in this appeal is of great importance to the minerals industry.

The amounts potentially at stake are substantial. In 1984, for example, United States mining and oil and gas companies, most of whom are represented by the *amici*, collectively paid over $7,000,000,000 in state severance taxes. Because deposits of hydrocarbons and hard minerals are concentrated in a limited number of States, approximately 80% of the foregoing 1984 severance tax payments went to only six States.[1] On the other hand, there are at least 30 States that impose no significant severance taxes.[2] These States would have nothing to lose, and everything to gain, if they could succeed in artificially increasing the amount of taxpayers' apportionable business income by adding back to true net income severance taxes and other production costs that are necessarily incurred outside the taxing States.

#### B. Since Severance Taxes and Other Mineral Production Costs Are Similar to the WPT, Non-Producing States May Attempt To Follow the New Jersey Approach by Disallowing Deductions for Those Costs

As a matter of *statutory* construction, the New Jersey Supreme Court had to conclude that the WPT

[1] In 1984, the States collected $7,248,943,000 in severance taxes. Of that amount, Alaska, Texas, Oklahoma, Louisiana, New Mexico and Wyoming collected approximately 80%. *Facts and Figures on Government Finance* e24-e25 (Tax Foundation, Inc. 23rd ed. 1986).

[2] As of 1984, 18 States (including New Jersey) had no severance tax revenues, and 12 other States had severance tax revenues of less than $10,000,000. *Ibid.*

was a tax "on or measured by profits or income" in order to add it back to the appellants' reported net income under the existing New Jersey statute. But there is nothing in the opinion of the court below suggesting that add-backs of this type are *constitutionally* limited to taxes "measured by profits or income." Accordingly, non-producing States may attempt to follow the New Jersey approach by disallowing deductions for severance taxes or other mineral production costs incurred outside the non-producing States.

Severance taxes, however computed, are a necessary cost of engaging in the businesses of producing oil and gas and mining hard minerals. In some jurisdictions, such taxes are based on the volume of production; in others, severance taxes are calculated with reference to the value of the production at the wellhead or mine.[3] But in all instances, the event giving rise to the tax liability is the extraction or severance of the hydrocarbons or minerals from the ground. Thus, severance taxes by their very nature relate to specifically identifiable operations that have an unambiguous geographical situs. In addition, severance taxes are imposed on each unit of production and do not relate to the overall profitability of the producer.

The WPT involved in this case is similar to state severance taxes. First, the WPT is imposed solely and exclusively in connection with oil *production* activities. As the court below noted, the WPT (J.S. App. 5a)—

> was imposed on production at the wellhead rather than on these integrated domestic producers'

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[3] See, *e.g.*, New Mexico Stat. Ann. §7-29-4 (1978); Tex. Code Ann. §§201.051, 201.052, 201.054 (1982).



> overall net profits or income ultimately calculated from gross sales and net profits as measured at the pump.

Mechanically, this is accomplished by imposing the WPT as each barrel of crude oil is "removed" from the producing premises by being brought to the surface and physically transported away from the immediate vicinity of the well. IRC, §4986(a); Treas. Regs. §51.4996-1(d)(1). Thus, the WPT clearly applies to production activities at a specific, identifiable location.

In addition to being triggered by the production of oil, the amount of the WPT is determined by the increase in value of the oil at the wellhead due to Federal price decontrol. IRC, §§4986(a), 4988(c), and 4989. Accordingly, the amount of "windfall profit" subject to the WPT involved in this case was determined on a barrel by barrel basis, solely by reference to activities in the production States—not in New Jersey. The court below acknowledged the limited geographical basis for determining the amount subject to tax, noting (J.S. App. 6a)—

> the basic measure of the windfall profit was the difference between the uncontrolled and controlled price *of a barrel of crude oil at the point the oil was removed from the producing property*. (Emphasis supplied.)

To be sure, the taxable "windfall profit" for each barrel of crude oil is subject to a net income limitation equal to "90 percent of the net income attributable to such barrel." IRC, §4988(b)(1). But even this lim-

itation is determined on a geographically limited basis.[4]

Finally, notwithstanding the per barrel net income limitation, the WPT is clearly not an income tax in the conventional sense. It is payable on the extraction of each profitable barrel even if the taxpayer's overall production operations (taking into account all barrels from all of its production properties) are unprofitable and even if the taxpayer's entire unitary business (including non-production activities) is unprofitable. The WPT is just as much a cost of production as the cost of operating the producing oil rig.

A non-producing State may seek to rely on these similarities between the WPT and state severance taxes as a justification for extending the rationale of the New Jersey Supreme Court to state severance taxes. In addition, such an approach might be taken by the non-producing States with respect to other geographically specific production costs. This case merits review by this Court because the numerous non-producing States should not be led to believe that they may constitutionally increase their revenues by disregarding billions of dollars of severance taxes (see n.1, *supra*) and other production costs that are necessarily incurred elsewhere. As we shall now show, any such action would be plainly unconstitutional.

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[4] The "net income attributable to a barrel" is determined by dividing "the taxable income *from the property* for the taxable year attributable to taxable crude oil" by "the number of barrels of taxable crude oil *from the property*." IRC, §4988(b)(2). (Emphasis supplied.)



## II. DISALLOWING DEDUCTIONS FOR EXPENSES, SUCH AS THE WPT, THAT ARE ATTRIBUTABLE SOLELY TO AN OUT-OF-STATE ACTIVITY VIOLATES THE DUE PROCESS, COMMERCE, AND EQUAL PROTECTION CLAUSES

### A. Due Process Clause

Under the Due Process Clause, a State may tax a corporation only on that portion of the corporation's income that is attributable to the corporation's activities in the taxing State. *Container Corp. v. Franchise Tax Bd.*, 463 U.S. 159, 164 (1983). The State may not tax "extraterritorial values" (*Butler Bros. v. McColgan*, 315 U.S. 501, 507 (1942)) or "tax value earned outside its borders" (*ASARCO Inc. v. Idaho State Tax Comm'n*, 458 U.S. 307, 315 (1982)).

In this case, as the New Jersey Supreme Court noted (J.S. App. 2a), appellants are vertically integrated oil companies engaged in all phases of the oil business, including exploration, production, refining, manufacturing, and marketing. All of appellants' production activities occur outside New Jersey. Their only New Jersey activities are limited to refining and marketing.

The issue, therefore, is to determine the portion of appellants' unitary business income that is attributable to their refining and marketing activities in New Jersey. That is all New Jersey may constitutionally tax. In fact, however, New Jersey seeks to tax more.

This can be demonstrated in several different ways. First, and most significantly, New Jersey's add back of the WPT, an expense incurred solely in connection with an out-of-state activity (production), is inconsistent with the entire theory of formulary appor-

tionment. Under formulary apportionment, the total income of the unitary business is ratably divided (on the basis of the apportionment factors employed) between the taxing State and all other jurisdictions in which the unitary business is conducted, so that the taxing State receives the same "rate of return"[5] as is earned by the entire business collectively.[6] See *Container*, 463 U.S. at 183, n.20. Thus, where, as here, the traditional three-factor apportionment formula is employed, the taxing State will receive the same amount of income for every dollar of payroll, property, and sales in the State as the entire unitary business earns, on the average, for every dollar of payroll, property, and sales in all locations.

To achieve this result, the apportionable business income of the unitary business must be consistently calculated for all phases of the business in order to reflect the contributions made in all locations. Pro-

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[5] The term "rate of return" is being used herein as a shorthand way of describing the ratio of income to the payroll, property, and sales producing that income.

[6] This can be demonstrated mathematically. The basic apportionment formula, using a single payroll, property, and sales ("PPS") factor for simplicity, is:

$$\text{unitary income} \times \frac{\text{state PPS}}{\text{total PPS}} = \text{state income}$$

Mathematically, this is equivalent to:

$$\frac{\text{state PPS}}{\text{total PPS}} = \frac{\text{state income}}{\text{unitary income}}$$

The "rate of return" everywhere will be the same because the foregoing equation can be rewritten:

$$\frac{\text{state income}}{\text{state PPS}} = \frac{\text{unitary income}}{\text{total PPS}}$$



vided this is done, formulary apportionment will produce a constitutionally acceptable result because the apportionment factors will fairly measure "the relative contribution of the activities in the [taxing State] to the production of the total unitary income." *Butler Bros.*, 315 U.S. at 509, quoting from the California Supreme Court opinion in that case.

By comparison, if the expenses of the in-state activities of an integrated unitary business are deducted in full in determining apportionable business income whereas certain expenses of out-of-state activities of the unitary business are not deducted, formulary apportionment cannot work. Under such circumstances, the apportionment factors will produce a different "rate of return" for the out-of-state activities than for the in-state activities, because the different constituent activities of the business were accounted for differently. By disallowing a deduction for certain expenses incurred solely in connection with out-of-state activities, the State is artificially inflating the amount of business income derived from those activities. Specifically, the State is including in apportionable business income the *gross* revenues *before* expenses from certain out-of-state activities (oil production in this case) and *net* income *after* expenses from the in-state activities (refining and marketing in this case). Using such a hybrid definition of apportionable income *necessarily* means that a taxpayer's "rate of return" on out-of-state activities will be greater than its "rate of return" on in-state activities. Such a result is "inherently arbitrary," and therefore a clear violation of the Due Process Clause. *Underwood Typewriter Co. v. Chamberlain*, 254 U.S. 113, 121 (1920).

The foregoing discussion would unquestionably apply if New Jersey were simply to disallow all non-New Jersey salary deductions, and we assume the State would not defend such a system. Obviously, pre-salary income from operations outside New Jersey should not be apportioned along with post-salary income from operations in New Jersey. But disallowing WPT is conceptually no different. The effect is to overstate the contribution of appellants' out-of-state production activities to the unitary business income of their integrated oil businesses. Furthermore, in view of the large amounts of WPT paid by appellants, the impact on their New Jersey tax liabilities is far in excess of any distortion that may be constitutionally tolerable. *Cf., Container*, 463 U.S. at 182-184.

Adding back WPT is conceptually far different from adding back Federal income taxes. Thus, it is no answer that the New Jersey Supreme Court held, for statutory purposes, that the WPT is a tax "paid or accrued to the United States on or measured by profits or income." Adding back Federal income taxes is perfectly consistent with the theory of formulary apportionment, which--

> owes its existence to the fact that with respect to a business earning income through a series of transactions beginning with manufacturing in one State and ending with a sale in another, a precise—or even wholly logical—determination of the State in which any specific portion of the income was earned is impossible. [*Moorman Mfg. Co. v. Bair*, 437 U.S. 267, 286 (1978) (Powell, J., dissenting)]

Since the Federal income tax is imposed on the entire net income of the unitary business, it burdens all



activities of the business equally. Thus, adding back Federal income taxes (or comparable state income taxes) does not disturb the relative apportionment of income to the different locations in which the unitary business is conducted. By comparison, as discussed above, the WPT is imposed only on production activities, without regard to the profitability of the unitary business as a whole. Thus, by adding back the WPT, New Jersey is effectively taxing a portion of the WPT plus the income fairly attributable to appellants' New Jersey activities.

The same point also is easily made by recalling that the imposition of WPT accompanied the phasing out of crude oil price controls. Thus, in effect, the Federal government took back a large portion of the "additional revenue resulting from decontrol." *United States v. Ptasynski*, 462 U.S. 74, 76 (1983). The combined effect of both decontrol plus the WPT was only a partial increase in producers' revenues. Yet, New Jersey treats the *full* amount of the WPT as increasing appellants' unitary income and thereby increasing the amount of that income attributed to appellants' New Jersey refining and marketing activities. This additional attribution is so clearly contrary to the actual facts that it constitutes a *per se* violation of the Due Process Clause.

### B. Commerce and Equal Protection Clauses

As a general proposition, the States have considerable leeway in determining what deductions will be allowable in computing the apportionable taxable income of a unitary business. But no State should be permitted to adopt a facially neutral rule that necessarily discriminates against a major class of taxpayers in actual practice. *American Trucking*

*Associations, Inc. v. Scheiner*, 107 S. Ct. 2829 (1987); *Westinghouse Electric Corp. v. Tully*, 466 U.S. 388 (1984).

The key fact in this case is that New Jersey produces no oil. Accordingly, New Jersey's facially neutral rule disallowing a deduction for certain oil production taxes necessarily discriminates against out-of-state producers who sell their end products in New Jersey, without adversely affecting any New Jersey based retailers who purchase similar products elsewhere for resale in New Jersey. In computing their apportionable business income that is subject to New Jersey tax, the out-of-state producers are allowed no deduction for the WPT. By contrast, local distributors who purchase the refined products for resale in New Jersey are allowed a full deduction for their cost of goods sold. As an economic matter, a distributor's cost of goods sold will always include the wellhead value of the crude oil, because that amount will be included in the price charged by the crude oil producer and passed on to every subsequent purchaser including the consumer. Since the WPT is based on the wellhead value of the oil and is payable out of the producer's wellhead selling price, the independent distributor's allowable cost of goods sold deduction necessarily subsumes the dollar amount of the WPT expense that New Jersey disallows as a deduction to the producer.

Thus, the out-of-state producer who sells refined products in New Jersey is denied a deduction that is effectively available to anyone else selling the same products in New Jersey. The effect of disallowing the deduction is, of course, to increase the out-of-state producer's total unitary business income, and, there-



fore, the amount of income that is apportioned to New Jersey under its standard three-factor apportionment formula. The resulting increase in New Jersey's tax revenues *cannot* be a fair reflection of the out-of-state producer's activities in New Jersey, because that increase is attributable *directly* and *solely* to production activities outside the State.

## CONCLUSION

Probable jurisdiction should be noted.

Respectfully submitted,


WILLIAM L. GOLDMAN*
GEORGE W. BEATTY
JAMES A. RIEDY
LEE, TOOMEY & KENT
1200 18th Street, N.W.
Washington, D.C. 20036
(202) 457-8500

**Counsel of Record*